Internal Revenue Service
MEMORANDUM

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to: Director, Tax Forms and Publications

from: Chief, CC:DOM:IT&A:5

subject: Form 2119, Sale of Your Home, and Instructions

You have asked us to advise you as to the basis treatment of improvements that are no longer part of a home sold. It has been proposed that all capital expenditures be added to the basis of the home, regardless of type and regardless of whether or not the improvement exists at the time of sale of the home.

Section 263(a) of the Internal Revenue Code provides in general that no deduction shall be allowed for (1) any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate and (2) any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

Section 1012 of the Internal Revenue Code provides that the basis of property shall be the cost of such property, except as provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.

Section 1016(a)(1) of the Code provides, in part, that as a general rule, proper adjustment in respect of the property shall in all cases be made ---

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no adjustment shall be made ---

(A) for taxes or other carrying charges described in section 266, or

(B) for expenditures described in section 173 (relating to circulation expenditures),

for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years.

Under paragraph (a)(2) an adjustment likewise is to be made for depreciation or amortization allowed or allowable in current or prior years after February 28, 1913.

In Otis v Commissioner, 73 T.C. 671 (1980) the issue was whether the taxpayer, who owned rental property, was entitled to a business expenses deduction for amounts expended for dishwashers, an air conditioner, a refrigerator, carpets and draperies.

The court stated that the taxpayer made the original expenditure that were required, and in fact did, treat the items as capital assets under 1.263(a)-2((a) of the income tax regulations. The court noted that the taxpayer depreciated the original cost over the useful life of each asset. The court concluded that the taxpayer simply expended funds under section 263(a)(2) "in making good the exhaustion" on their property upon which the allowance for depreciation had been allowed and denied the expense deduction.

With respect to business property, under the accelerated cost recovery system of depreciation, some taxpayers are not allowed a loss on replacement of a retirement but must continue to depreciate the old item. Section 1.168-6(b) of the proposed regulations makes reference to section 168(l)(1) for the definition of "disposition:, which excludes the retirement of a structural component of 15-year real property. Thus, no loss will be recognized on such retirement, and the unadjusted basis under section 1.168-2(d) should not be reduced. For example, if the taxpayer replaces the roof on a 15-year real property, no loss is recognized upon the retirement of the replaced roof, and the unadjusted basis of the property continues to be recovered over the remaining period.

In Deposit Trust & Savings Bank v. Commissioner, 11 B.T.A. 706 (1928), the court concluded that in determining the gain or loss on the sale of residence property, the homeowner was not required to reduce his basis by an amount for depreciation because the homeowner was not entitled to take a deduction for yearly depreciation under the Code.

Therefore, considering Otis, the general rule for business taxpayers would be that if you replace property that has not been depreciated a taxpayer would generally be allowed a business deduction.

We believe a similar rule could apply for homeowners who replace property that is not depreciated, whereby although a section 162 deduction would not be allowed, the homeowner would treat such expenditure as an out of pocket expense without capitalization and the original cost basis would remain intact.

Director, TF:P

However, if a homeowner capitalizes the replacement carpets or other replacement appliances to the basis of the home, the homeowner should not continue to include in the basis of the home those improvements which were replaced and are no longer part of the main home. To rule otherwise would result in the taxpayer recognizing less gain on a sales transaction while having the privilege of utilizing the property. As in Deposit Trust, where unallowed depreciation was not taken into consideration in arriving at a gain or loss, we believe property which was once capitalized and is no longer part of the home, which is now replaced with other property that is capitalized, should not be included in basis and in essence be double counted (the original capitalized amount and the replacement capitalized amount) in arriving at the gain or loss.

(signed) David L. Crawford

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